

RECEIVED

AUG 31 2004

Dept. Of Commerce & Insurance
Company Examinations

REPORT ON EXAMINATION
OF
DISTRIBUTORS INSURANCE COMPANY
Chattanooga, Tennessee

as of
December 31, 2002

THE DEPARTMENT OF COMMERCE AND INSURANCE
STATE OF TENNESSEE
Nashville, Tennessee

TABLE OF CONTENTS

<u>Item</u>	<u>Page</u>
Salutation.....	one
Introduction.....	1
Scope of Examination.....	1
Location of Books and Records.....	2
Previous Examination Comments and Recommendations.....	3
Company History	3
Dividends.....	5
Growth of Company.....	5
Charter and Bylaws	5
Management and Control	8
Management Agreements	10
Pecuniary Interest.....	11
Conflict of Interest Policy	11
Corporate Records	12
Holding Company Structure.....	12
Fidelity Bond and Other Insurance	12
Territory	13
Schedule T – Exhibit of Premiums Written	13
Plan of Operation.....	13
Market Conduct Activities	14
Policy Forms and Rates.....	14
Underwriting	15
Advertising.....	15
Claims Review.....	15
Policyholder Complaints	15
Privacy.....	15
Anti-Fraud Plans.....	15
Reinsurance	16
Assumed.....	16
Retirement Plan and Other Employee Benefits	17
Loss Experience	18
Accounts and Records.....	19
Statutory Deposits	19
Litigation	30
Subsequent Events	20
Financial Statement.....	22
Assets.....	22
Liabilities, Surplus and Other Funds.....	23
Statement of Income.....	24
Reconciliation of Capital and Surplus for the Period under Examination.....	25
Analysis of Changes in Financial Statement and Comments Resulting From Examination.....	26
Summary Schedule for “Analysis of Changes in Financial Statement and Comments Resulting From Examination” as They Affect Surplus	26

Comments and Recommendations	27
Conclusion.....	28
Affidavit.....	29
Organizational Chart.....	30

Chattanooga, Tennessee
August 31, 2004

Honorable Paula A. Flowers
Commissioner of Commerce and Insurance
State of Tennessee
500 James Robertson Parkway
Nashville, Tennessee 37243

Dear Commissioner:

Pursuant to your instructions and in accordance with Tennessee Insurance laws, regulations and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a financial examination and market conduct review was made of the condition and affairs of the

DISTRIBUTORS INSURANCE COMPANY
CHATTANOOGA, TENNESSEE

hereinafter generally referred to as the Company, and a report thereon is submitted as follows:

INTRODUCTION

This examination was called by the Commissioner of Commerce and Insurance of the State of Tennessee and commenced on May 12, 2003. The examination was conducted under the association plan of the NAIC by duly authorized representatives of "The Department of Commerce and Insurance", State of Tennessee.

SCOPE OF EXAMINATION

The period covered hereunder is from December 31, 1997, the date of the last examination, to the close of business on December 31, 2002, the date of this examination. The examination was conducted at the Company's office at 1206 Broad Street, Chattanooga, Tennessee 37402.

Location of Books and Records:

The Company keeps its charter, bylaws, corporate minutes, policy files, correspondence files, bank statements, investment records, reinsurance contracts, copies of claim runs and accounting records at its home office at 1206 Broad Street, Chattanooga, Tennessee 37402. The Company has records for underwriting, policy issuance, marketing and other financial management records at Acordia, 1100 Johnson Ferry Road, Suite 250, Atlanta, Georgia 30342. Accounting records and statutory statement records are maintained at Willis Management (Vermont), Ltd., 112 Lake Street, Burlington, Vermont 05401. Subsequent to the examination date the address for Willis changed to 1 Lawson Lane, Suite 410, Burlington, Vermont 05401. Records for workers' compensation claims are maintained by Claims Management Services, Inc. at 360 Market Place, Roswell, Georgia 30077-1477. Records for general liability claims are maintained by GAB Robins North America, Inc. at 3340 Peachtree Road NE, Atlanta, Georgia 30326.

The examination of the financial condition was conducted in accordance with guidelines and procedures contained in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. During the course of examination, assets were verified and valued and liabilities were determined and estimated as of December 31, 2002. The financial condition of the Company and its amount of solvency were thereby established. Test checks were made of income and disbursement items for selected periods, and a general review was made of the Company's operations, practices, and compliance with applicable statutes and regulations. All asset and liability items contained in the financial statement of this report were examined and verified with relative emphasis according to their amount and potential impact on capital and surplus.

Also, an examination was made into the following matters:

- Company History
- Charter and Bylaws
- Management and Control
- Corporate Records
- Fidelity Bond and Other Insurance
- Territory
- Plan of Operation
- Market Conduct Activities
- Reinsurance
- Retirement Plan and Other Employee Benefits
- Loss Experience
- Accounts and Records
- Statutory Deposit
- Litigation

Subsequent Events
Financial Statement

Previous Examination Comments and Recommendations:

The following comments and recommendations were contained in the December 31, 1997 examination report:

Comments

Statutory Deposits

Although the Company lists a total of \$750,000 in Special Deposits in Schedule E, Part 2 of its 1997 Annual Statement, this examination has found that these are actually General Deposits, which are held for the benefit of all policyholders and creditors of the Company.

Recommendations

Bonds The Company had not filed all of its bonds with the Securities Valuation Office of the National Association of Insurance Commissioners as required by Chapter 0780-1-37-.01 of the Regulations of the Tennessee Department of Commerce and Insurance. It is recommended that the Company submit all securities to the Securities Valuation Office in the future.

The Company had still listed the deposits as special deposits in the December 31, 2002 annual statement. Subsequent to the 1997 examination report, management sought guidance on this issue from the Department but did not receive clarification.

The Company had submitted its securities to the Securities Valuation Office.

COMPANY HISTORY

The Company was incorporated on April 12, 1983, pursuant to the provisions of the Tennessee General Corporation Act with the name Distributors Insurance Company and principal office location at 831 Chestnut Street, Chattanooga, Tennessee 37402. The initial capitalization of the Company was authorized for a maximum number of 2,000 shares of no par value common stock.

By declaration of its sole incorporator on April 19, 1983, the Company accepted a

subscription from Tennessee Valley Public Power Association for 100 shares. The total consideration for these 100 shares was \$1,000. On June 22, 1983, an additional 100 shares were issued to Tennessee Valley Public Power Association for a total consideration of \$1,000,000. The consideration was in the form of an irrevocable letter of credit of \$1,000,000, guaranteed by the Tennessee Valley Authority and issued by a local financial institution in favor of the Commissioner of "The Department of Commerce and Insurance" of the State of Tennessee for the benefit of the Company's policyholders. The capital paid in account was credited with \$600,000 and gross paid in and contributed surplus was credited with \$400,000.

Under an agreement dated June 8, 1983, the Tennessee Valley Authority guaranteed the issuance of up to three million dollars (\$3,000,000) of letters of credit to the Company. The letter or letters of credit will be utilized until such time as capital and surplus derived from premium income of the Company may be substituted therefore; provided, however, in no event will any such letters of credit extend in effect for more than 10 years from the date of the initial letter of credit provided by TVA. On July 28, 1983, a supplement to the June 8, 1983 agreement was entered into by the parties. The total amount of letters of credit was increased to a maximum of five million dollars (\$5,000,000). This limit includes letters of credit issued in favor of fronting insurance companies and reinsurance companies which require the letters in order to provide the Company with fronting insurance services or reinsurance services.

On April 27, 1986, gross paid in and contributed surplus was increased by \$1,500,000. The consideration was in the form of \$500,000 cash and a letter of credit for \$1,000,000.

Pursuant to the 1986 changes enacted into law concerning capital requirements, the Company on April 28, 1986, reduced its capital paid in account from \$601,000 to \$400,000. The \$201,000 capital reduction was transferred to gross paid in and contributed surplus. On December 11, 1986, gross paid in and surplus was increased by \$250,000 from TVPPA.

On April 29, 1992, the Company received approval from "The Department of Commerce and Insurance", State of Tennessee, to non-renew \$1,000,000 of the \$2,000,000 TVA guaranteed letters of credit issued by TVPPA. On July 1, 1992, the maturity date of the letters of credit, one of the letters was allowed to non-renew and the gross paid in and contributed surplus account was reduced accordingly. On June 21, 1993, the remaining letter of credit was retired.

At December 31, 2002, common capital stock had a balance of \$400,000 and gross paid in and contributed surplus had a balance of \$351,000. There were 200

shares of common stock outstanding.

Dividends:

The Company paid no dividends during the period under examination.

Growth of Company:

The following exhibit depicts certain aspects of the growth and financial history of the Company since the previous examination, based upon the annual statements filed with "The Department of Commerce and Insurance", State of Tennessee

<u>Year</u>	<u>Written Premiums</u>	<u>Earned Premiums</u>	<u>Losses and LAE paid</u>	<u>Admitted Assets</u>	<u>Capital and Surplus</u>
1998	\$2,410,541	\$2,587,336	\$1,653,764	\$16,940,731	\$7,767,337
1999	2,311,816	2,287,353	1,743,062	16,243,177	8,399,849
2000	2,540,699	2,500,073	1,465,915	15,853,606	8,762,289
2001	2,318,252	2,465,400	1,376,638	16,563,266	9,336,111
2002	3,053,042	2,760,131	1,368,728	16,607,946	9,457,963

CHARTER AND BYLAWS

Charter:

The original charter of incorporation of the Company was filed and recorded with the Secretary of State for the State of Tennessee on April 12, 1983. The charter was filed and recorded in the Register's Office of Hamilton County at Chattanooga, Tennessee on May 10, 1983. According to its charter, the Company was organized for the following purposes:

- (a) To make all types and forms of insurance and reinsurance permitted or authorized for an association captive insurance company by the "Tennessee Captive Insurance Company Act" codified as Tennessee Code Annotated Sections 56-13-101 et seq.
- (b) To provide any and all kinds of insurance services and other services related thereto, including, without limitation, agency or brokerage services, management services, claims services, loss control services, inspection

services, underwriting services, actuarial services, data processing services, and consulting services of any kind and nature whatsoever.

- (c) To engage in any lawful act or activity in which corporations organized under the Tennessee General Corporation Act may engage.

On December 31, 2002 the Board of Directors adopted, by written consent, to amend its charter. This amendment was approved by "The Department of Commerce and Insurance", State of Tennessee on June 18, 2003. The amendment was filed with the Secretary of State of the State of Tennessee on August 14, 2003 and with the Register of Deeds of Hamilton County, Tennessee on August 26, 2003. This amendment changed the address of the principal office of the Company to 1206 Broad Street, Chattanooga, Tennessee 37402.

As originally adopted, the charter also provided that the Company shall exist perpetually as a for profit corporation.

Bylaws:

The bylaws of the Company in effect at December 31, 2002, were amended on December 10, 2002 when the shareholder approved the amendment of Article I to change the principal office location and Article III, Section 2 to reflect a more precise definition of eligibility of Company directors. The bylaws contain the following provisions among others:

- The principal office of the Company shall be maintained at the address designated in its charter, 1206 Broad Street, Chattanooga, Tennessee 37402.
- Annual shareholder meetings shall be held at the call of the Board of Directors. The annual meeting shall be held at ten o'clock in the morning on the second Monday of May of each year or at such other date and time as shall be designated in the notice of the meeting. The Board of Directors may designate any place as the place of meeting for any annual shareholders' meeting. Special meetings of the shareholders may be called at any time by the Chairman of the Board, the President, the Board, or any two Directors, and shall be called by the President at the request of the holders of not less than one tenth of the outstanding shares of the capital stock of the Company. Written notice stating the place, day and hour of annual and special meetings shall be given to each shareholder, either personally or by mail to the stockholder's last address of record with the Company, not less than five (5) nor more than sixty (60) days before the date of a meeting. At all meetings of shareholders a majority of the

outstanding shares of stock entitled to vote, represented in person or by proxy, shall constitute a quorum for the transaction of business. Whenever the shareholders or directors of the Company are required or permitted to take any action by vote, such action may be taken without a meeting or written consent, setting forth the action so taken, signed by all of the persons or entities entitled to vote thereon. Participation by members of the Board in any telephone meeting of the Board by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other shall be permitted. Participation in such a meeting shall constitute presence in person at such meeting.

- The bylaws, as amended, provide that the business and affairs of the Company shall be managed by the Board of Directors, each of whom shall be either the person with primary management responsibilities for a Regular Member of the Tennessee Valley Public Power Association, or an officer, agent or employee of the Tennessee Valley Public Power Association or of the Company. The Board of Directors shall consist of two classes of Directors, Class A and Class B, all of whom shall be equal in duties, privileges, and responsibilities, except as to the manner in which they are selected or designated to serve as directors. The number of Class A Directors of the Company shall not be less than five (5) or more than thirteen (13), as may be established by resolutions of the shareholders. Except for the filling of a vacancy in the office of Class A Directors for an unexpired term, the election for the office of Class A Directors shall be at the annual meeting of the shareholders by the affirmative vote of a majority of the shares represented at the annual meeting. Except in the case of death, resignation, retirement, disqualification, or removal, each Class A Director shall serve for terms of two years until the second succeeding annual meeting and thereafter until his successor shall have been elected and qualified; provided, however, when the first Board of Directors shall be appointed, the resolution of the shareholders shall provide for staggered terms of the Directors so that the terms of half, or as near to half as may be practicable, shall expire each year. No Class A Director shall serve for more than three consecutive terms. The Class B Director shall be one in number and shall be that person elected Chairman of the Tennessee Valley Public Power Association ("TVPPA") and who by virtue of his office shall serve as a director for a term concurrent with the term of office as Chairman of the TVPPA.
- Regular meetings of the directors shall be held after the annual meeting of shareholders or any meeting held in lieu thereof. In addition, the Board of Directors may schedule other meetings to occur at regular intervals throughout the year. Special meetings of the Board of Directors may be called by or at the

request of the Chairman of the Board or at the request of the President, or, in the absence of both such officers, by the Secretary of the Company, or by a majority of the directors in office at that time. At meetings of the Board of Directors, a majority of the total number of directors shall constitute a quorum for the transaction of business. The act of a majority of the directors present at a meeting at which a quorum is present at the time shall be the act of the Board of Directors.

- By resolution adopted by the full Board of Directors, the Board of Directors may designate an executive committee, an investment committee, which shall include the Treasurer of the Company, a claims review committee, which shall include the General Counsel of the Company, an underwriting standards committee and/or any other committee or committees for any purpose or purposes to the extent lawful, which shall have the full powers as shall be specified in the resolution of appointment. A majority of the membership of each such committee shall be Directors of the Company.
- All officers of the Company shall be elected by the Board of Directors and shall serve for terms of one (1) year each and until their successors have been elected and qualified, or until their earlier death, resignation, removal, retirement or disqualification. Any officer elected or appointed by the Board of Directors may be removed by the Board of Directors. The officers of the Company shall consist of a Chairman of the Board, President, Vice President, Secretary and Treasurer, and such other officers as shall, from time to time, be chosen and elected by the Board of Directors. Not less than one corporate officer shall be a resident of the State of Tennessee.

The shareholders of the Company shall have the power to alter, amend or repeal the bylaws or adopt new bylaws at any regular or special meeting of the shareholders.

MANAGEMENT AND CONTROL

Management:

Management of the Company and control of its property are vested in its Board of Directors. As of December 31, 2002, the following persons were serving two year terms on the Board of Directors of the Company and were elected at the annual shareholders meetings on May 16, 2001 and May 8, 2002.

DIRECTOR**OCCUPATION**

John D. Burt	Manager Philadelphia Utilities Philadelphia, Mississippi
James O. Clark	General Manager Columbia Tennessee Power and Water Systems Columbia, Tennessee
Harold E. DePriest	President and Chief Executive Officer Electric Power Board of Chattanooga Chattanooga, Tennessee
Ron Hutchins	General Manager North Georgia Electric Membership Corporation Dalton, Georgia
Greg McClain	Assistant City Manager City of Maryville Maryville, Tennessee
Larry K. Musick	Superintendent Franklin Electric Plant Board Franklin, Kentucky
James E. Peeler	Manager Dickson Electric System Dickson, Tennessee
David E. Scarbrough	Superintendent Milan Department of Public Utilities Milan, Tennessee
David B. Thornton	Manager Tuscumbia Utilities Tuscumbia, Alabama

As of December 31, 2002, the following persons held office in the Company as elected by the Board of Directors at its meeting on May 19, 2002:

NAME**OFFICE**

Larry K. Musick	Chairman of the Board
-----------------	-----------------------

David E. Scarbrough
Richard C. Crawford
R. Kent Lopez

Vice Chairman of the Board
President
Vice President, Secretary and Treasurer

The following persons were serving on the Investment Committee at December 31, 2002:

Harold E. DePriest, Chairman
James O. Clark
R. Kent Lopez
Larry K. Musick
James E. Peeler
David E. Scarbrough

The following persons were serving on the Claims Committee at December 31, 2002:

David E. Scarbrough, Chairman
John D. Burt
Ron Hutchins
Greg McClain
Larry K. Musick
Carlos C. Smith
David E. Thornton

Management Agreements:

The Company entered into an Insurance Management Agreement with Acordia Southeast Inc. and Acordia, Inc. effective November 1, 1999 through December 31, 2000. On November 28, 2000 the agreement was extended through December 31, 2002.

Under the agreement Acordia provides the Company with management, administrative and consulting services. Acordia provides underwriting, policyholder service, billing collection, marketing, claims service, reinsurance, advisory service and management. Acordia also aids and assists in the recruitment, training and supervision of such full-time employees or staff as the Company elects to hire. Under the agreement, the Company is provided accounting services, financial reports, and all reports and applications required by the Tennessee Captive Insurance Act. The current agreement was entered into following the termination of the previous management agreement with Willis Corroon.

Under the management agreement, Acordia arranges for the provision of claims service for the Company. The claims service providers selected were GAB Robins North America, Inc. and Claims Management Services, Inc.

The Company and Tennessee Valley Public Power Association have an operating agreement whereby TVPPA furnishes the Company office space, personnel, office equipment, office supplies and other miscellaneous support functions. There is no formal written agreement. The agreed upon percentages for allocation of expenses between the parties are based upon the annual TVPPA budget and are used for quarterly payments by the Company to TVPPA. The agreement appears to be fair to both parties and consistently applied during the period under examination.

Pecuniary Interest:

A check for compliance with Tenn. Code Ann. § 56-3-103 found that no director or officer of the Company had a pecuniary interest in the investment or disposition of Company funds.

Conflict of Interest Policy:

The Company had reported in its annual statement that it had a conflict of interest policy in effect. This was determined to be incorrect. The firm that prepares the annual statement apparently made a clerical mistake in the preparation of the annual statement, which management did not notice when signing the annual statement. On April 22, 2004 the Company adopted a conflict of interest policy.

Control:

Ownership and control of the Company rests in Tennessee Valley Public Power Association (TVPPA), a Tennessee not-for-profit corporation whose membership consists of municipal and cooperative distributors of power purchased from the Tennessee Valley Authority. The Company's charter restricts its ownership to TVPPA.

During the period under review, five (5) regular annual shareholder meetings were held. In addition, the management of the Company routinely reports on the Company's activities at the regular meetings of the Board of Directors of TVPPA. The TVPPA Board always includes at least one Company director, and TVPPA's meetings generally occur at least four times per year.

CORPORATE RECORDS

The minutes of the meetings of the shareholders and Board of Directors of the Company were reviewed for the period subject to this examination. Such minutes appeared to report sufficiently the content of each respective meeting.

HOLDING COMPANY STRUCTURE

An organizational chart of the Company and its parent is located on the last page of this examination report. The following agreements between the Company and its parent were in effect at December 31, 2002:

1. TVPPA entered into a loss control consulting agreement with Roger Plymale and R. P. & Associates for a three year period beginning January 1, 2002. The Company agreed to pay TVPPA the sum of \$192,250 for the time period January 1, 2002 through December 31, 2002; the sum of \$197,540 for 2003; and \$202,880 for 2004.
2. TVPPA entered into a safety training agreement with Joe Gentry and Gentry & Associates for a three year period beginning January 1, 2002. The Company agreed to pay TVPPA the sum of \$171,250 for the time period January 1, 2002 through December 31, 2002; the sum of \$177,540 for 2003; and \$183,880 for 2004.
3. TVPPA entered into a safety training agreement with John Towler for a three year period beginning January 1, 2002. The fees for services were \$650 per location visit of six hours. The Company agreed to pay TVPPA 25% of all sums paid to Towler.

These service agreements were not filed with "The Department of Commerce and Insurance" pursuant to Tenn. Code Ann. § 56-11-206(a)(2)(D).

FIDELITY BOND AND OTHER INSURANCE

The following insurance coverages with described limits of liability were in effect at December 31, 2002 and as of the date of this examination report:

Types of Coverage**Limits of Liability**

- | | |
|--|---|
| 1. Financial Institutions Bond | \$1,000,000 Aggregate
\$1,000,000 Single Limit
\$ 10,000 Deductible |
| 2. Directors and Officers Liability
and Company Reimbursement | \$5,000,000 Aggregate
\$ 100,000 Deductible |

Each of the coverages was issued by an insurance company authorized to transact business in the State of Tennessee. The minimum amount of the fidelity coverage for the Company based upon the amounts included in its 2002 Annual Statement as used in the calculation prescribed in the Financial Condition Examiners Handbook of the National Association of Insurance Commissioners was \$150,000. As noted above the Company had fidelity coverage which exceeded the minimum suggested coverage by a comfortable margin.

TERRITORY

As of December 31, 2002, the Company was licensed to transact insurance business only in the State of Tennessee. By using a fronting carrier through Acordia Southeast, Inc., the Company is able to assume coverage of other TVPPA members in the states of Alabama, Georgia, Kentucky, Mississippi, North Carolina and Virginia.

SCHEDULE T – EXHIBIT OF PREMIUMS WRITTEN

Direct Premiums Written	Direct Premiums Earned	Direct Losses Paid	Direct Losses Incurred	Direct Losses Unpaid
\$1,129,768	\$929,963	\$220,468	\$276,821	\$864,017

PLAN OF OPERATION

The Company's plan is to operate a captive insurance company wholly owned by the Tennessee Valley Public Power Association that provides property and casualty insurance to TVPPA's 157 members. Association members generally purchase \$1,000,000 limits of coverage for auto liability, employer's liability and general liability,

actual cash value limits for auto physical damage, and statutory limits for workers' compensation from a fronting insurance carrier. Distributors then assumes the first \$100,000 layer per occurrence of coverage (see "Reinsurance" section of exam report). General liability is written on a direct basis in Tennessee, also with \$100,000 per occurrence limits.

The Company uses the captive management services of Acordia to carry out its plan. In accordance with a formal written agreement, the management company works with local independent agents, fronting companies and reinsurance companies to place coverages with the Company on behalf of the participating members of the TVPPA.

The management company is responsible for marketing the insurance programs offered by the Company to the members of the TVPPA, issuing and canceling policies, and billing and collecting premiums. The management company is also responsible for providing all accounting services, and reports used by the Company, securing on behalf of the Company appropriate facultative or treaty reinsurance and arranging for claims service through a provider acceptable to the Company. The Company has a contract with GAB Robins, Inc. to accept, review and investigate claims, establish and maintain claims files, adjust and settle or resist claims, and to provide such accounting reports that detail loss payments and outstanding reserves on open claims.

MARKET CONDUCT ACTIVITIES

In accordance with the policy of "The Department of Commerce and Insurance", a market conduct review was made of the Company as of December 31, 2002 in conjunction with this examination. The following items were addressed:

Policy Forms and Rates:

Under Tenn. Code Ann. § 56-13-123, the Commissioner may require all captive insurance companies to file with the Commissioner a copy of any policy, certificate, or contract of insurance to be delivered or issued for delivery in this state, or any endorsement, rider, or application which becomes a part of such policy, certificate, or contract of insurance. Based upon information received from inquiry with departmental personnel, it was determined that there was no evidence of the Company having filed any policy forms, nor was there any evidence of the Department ever having requested or requiring the Company to file policy forms.

Under Tenn. Code Ann. § 56-13-125, the Commissioner may require all captive insurance companies to file with the Commissioner every manner of classification, rules and rates, every rating plan and every modification of any of these which it proposes to use. Based upon information received from inquiry with departmental personnel, it was determined that there was no evidence of the Company having filed any rates, nor was

there any evidence of the Department ever having requested or requiring the Company to file any rates.

Underwriting:

The underwriting function is done by Acordia under the management services agreement. A casualty rating sheet is prepared for each account which shows the manual premiums. The manual premiums are subject to modification depending on loss experience and evaluation of safety and loss control procedures. The rates are based on filings with the states by the insurers from which the Company assumes reinsurance.

Advertising:

The Company maintains an advertising file. The advertising program consists of a Company internet website and printed advertisements in TVPPA trade publications. The advertising file was reviewed and appears to be in compliance with applicable statutes and regulations.

Claims Review:

A sample of open and closed claim files reviewed during the examination indicated that claims were being paid in accordance with policy provisions and settlements were made promptly upon receipt of proper evidence of the Company's liability. Company personnel, legal counsel, and the management company's personnel review all claims of \$25,000 or more.

Policyholder Complaints:

Inquiries made to the various policyholders' service offices indicated no regulatory concerns with the Company during the period under examination. No unusual practices or items warranting criticism of the Company were noted.

Privacy:

The Company is not subject to Tenn. Comp. R. & Reg. §0780-1-72 since it does not insure or transact business with any individuals.

Anti-Fraud Plans:

The Company is exempt from Tenn. Code Ann. § 56-53-111 because it does not have direct written premiums exceeding ten million dollars (\$10,000,000).

REINSURANCE

Assumed:

At December 31, 2002, a reinsurance agreement was in effect between the Company and National Union Fire Insurance Company of Pittsburgh, PA. This agreement became effective October 1, 1985, and shall remain in effect until terminated. The agreement has been amended by an addendum in several instances.

Under the agreement the Company assumes the first one hundred thousand dollars (\$100,000) per occurrence of ultimate net loss under any and all policies of General Liability, Automobile Liability and Workers' Compensation insurance issued or entered into by or on behalf of National Union by or at the instance of the management company. The Company obligates itself to accept as reinsurance one hundred percent (100%) of the ultimate net loss under any and all policies of Automobile Physical Damage insurance issued or entered into by or on behalf of National Union by or at the instance of the management company. The Company has placed a letter of credit for \$938,000 with National Union to secure its obligations.

The above referenced reinsurance agreement contains the standard provisions generally found in such agreements, including an arbitration article, an errors and omissions article and an insolvency article.

Effective July 1, 2001 the Company terminated the agreement which was placed in runoff.

Effective July 1, 2001 the Company entered into a reinsurance agreement with Lexington Insurance Company. Under the agreement the Company assumes the first \$100,000 of losses of the commercial general liability policies issued to members of the Tennessee Valley Public Power Association outside of Tennessee. The Company pays Lexington a 23% ceding commission. The Company assumed \$384,998 of premiums.

The agreement contains a right of offset, errors or omissions, inspection, arbitration and insolvency clauses. The agreement is continuous until terminated. The agreement may be cancelled by either party at any time by giving not less than 180 days prior written notice by certified mail. The Company has placed a letter of credit for \$1,000,000 with Lexington to secure its obligations.

On June 30, 2001 the Company entered into a reinsurance agreement with Federal Insurance Company, represented by Chubb & Son, a division of Federal Insurance Company, as manager. The agreement expires on June 30, 2004 unless terminated earlier. Under the agreement the Company assumes the first \$100,000 per occurrence of the ceding company's ultimate net loss for all new and renewal policies issued to the members of the Tennessee Valley Public Power Association, and/or their subsidiaries and affiliates, under policies providing coverage for workers' compensation,

general liability, automobile liability and auto physical damage. In addition to the ultimate net loss, the Company will pay 100% of the loss adjustment expenses on any claim on which the ultimate net loss does not exceed \$100,000; and for claims which the ultimate net loss exceeds \$100,000, the Company will pay in proportion to the ratio that the ultimate net loss paid by the Company bears to the total amount of the loss.

The Company pays a ceding commission of 9% of net premiums. The Company assumed \$1,358,448 of premiums. The Company has placed a letter of credit for \$890,688 to secure its obligations.

The agreement contains a right of offset, errors or omissions, inspection, arbitration and insolvency clauses. The agreement may be cancelled by either party at any time by giving not less than 120 days prior written notice by certified mail.

At December 31, 2002, an aggregate excess workers' compensation and employer's indemnity policy was in effect between the Company and Distributors Self Insurance Fund (DSIF), which is a division of the Company. The term of the agreement is from July 1, 2002 until July 1, 2003. Under this policy the Company indemnifies DSIF for workers' compensation losses in excess of 75% of DSIF's earned premium up to \$250,000 per occurrence with a \$1,000,000 limit of liability excess of DSIF's retained losses within the policy period. The premium for this policy is equal to 4.3% of DSIF's earned premium during the policy period. DSIF is required to remain a duly-qualified self-insurance fund in Tennessee for the agreement to remain in effect.

RETIREMENT PLAN AND OTHER EMPLOYEE BENEFITS

TVPPA provides its employees with a defined-benefit pension plan. The Company's employees are employees of TVPPA. While they are subject to the direction of the Company's Board of Directors, their compensation and fringe benefits are actually paid directly by TVPPA, then the Company reimburses TVPPA for their allocable and proportional share of these expenses under an operating agreement. The plan provides a defined monthly pension for each participant at retirement. The plan is a group annuity contract. TVPPA pays the bulk of the annual premium and the employee contributes 1.5 percent of gross pay annually. The plan multiplier is 2.25 by the average monthly salary (based on highest five years earnings) multiplied by the years of contributory service, which equals the monthly plan benefit for 120 months after retirement.

On January 1, 1997, TVPPA adopted a 401(k) profit sharing plan. This qualified plan is administered by National Rural Electric Cooperative Association to provide financial benefit to employees upon their retirement or to their dependents and beneficiaries in the event of their death. It allows participating employees to defer a

specific amount of their salary before taxes (an amount which cannot exceed a dollar amount set by law) for contribution by the association into the plan for the benefit of each participating employee. The association does not provide a match or any other amount of employer contribution to the plan at this time.

Employees of TVPPA are provided paid annual leave, holidays, sick leave and personal leave. Annual leave is based upon the number of years of continuous service with TVPPA. TVPPA has eleven paid holidays. Sick leave is accumulated at the rate of one day per month with no limit on accumulation. Personal leave of up to three hours monthly (not cumulative) shall be granted to allow each employee time off for medical appointments, emergencies, or other personal reasons.

TVPPA provides a comprehensive range of benefits to the employees under a group insurance program. The types of coverage included in the plan are as follows:

- Life Insurance
- Accidental Death & Dismemberment Coverage
- Business Travel Accident Coverage
- Group Major Medical Expense Benefits
- Long Term Disability Benefits
- Comprehensive Dental Expense Benefits

TVPPA pays all premiums for the employees' group insurance plan.

LOSS EXPERIENCE

The ratios of losses incurred to premiums earned for each line as reported in the Company's annual statements for the years indicated were as follows:

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
<u>Workers' Compensation</u>	454,822	20,140	178,073	205,270	28,610
	572,294	382,140	366,990	344,880	447,159
	80%	5%	49%	60%	6%
<u>Other Liability</u>	113,843	497,007	386,947	282,858	460,423
	1,153,491	1,041,113	1,184,370	1,178,280	1,297,213
	10%	48%	33%	24%	36%
<u>Automobile Liability</u>	257,734	144,612	188,376	368,846	316,664

	694,341	656,968	702,329	688,130	725,765
	37%	22%	27%	54%	44%
<u>Auto Physical Damage</u>	61,796	110,909	46,612	101,302	68,462
	167,210	207,132	246,384	254,090	289,994
	37%	54%	19%	40%	24%
<u>Combined (All Lines)</u>	888,195	772,668	800,008	958,276	874,159
	2,587,336	2,287,853	2,500,073	2,465,400	2,760,131
	34%	34%	32%	39%	32%

ACCOUNTS AND RECORDS

During the course of examination, such tests and audit procedures were made as were considered necessary, including substantial verification of postings, extensions and footings and reconciliation of subsidiary ledgers to control accounts where necessary. General ledger trial balances were reconciled with copies of annual statements for the years 1998, 1999, 2000, 2001 and 2002.

Accounting records conform to generally accepted insurance accounting practices and appear to properly reflect the operations during the period under examination and the status of the Company at the date of examination.

The Company's Risk Based Capital Report was reviewed and found to be in compliance with requirements.

The Company retains the independent certified accounting firm of Johnson Lambert & Co. for audit and income tax reporting purposes. This firm has been performing the annual audit of the Company since 2001; therefore, there is no violation as respects Tenn. Comp. R. & Regs. §0780-1-65.07(3).

STATUTORY DEPOSIT

The Company maintains a deposit with the State of Tennessee for the benefit of all policyholders. As of December 31, 2002, this deposit was as follows:

<u>Description</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Hawaii State General Obligation, 4.9%, Due 3/01/2004, Cusip No. 419780BF7	\$250,000	\$250,000	\$260,555
Marshall County, WV Special Obligation, 6.5%, Due 5/15/2005, Cusip No. 572314 AL6	\$250,000	\$249,190	\$288,315
Mississippi State Refunding General Obligation, 5.8%, Due 11/15/2007, Cusip No. 605575MX4	<u>\$250,000</u>	<u>\$249,800</u>	<u>\$255,880</u>
<u>Totals</u>	<u>\$750,000</u>	<u>\$748,990</u>	<u>\$804,750</u>

Verification was by direct correspondence with the custodian of such funds. The Company had incorrectly shown the deposit as a special deposit. This was addressed in the prior examination report.

LITIGATION

As of December 31, 2002, the Company had no pending litigation, other than that arising out of the normal course of business, which would adversely affect the financial condition of the Company.

SUBSEQUENT EVENTS

Distributors Self Insurance Fund (DSIF) is a self insurance fund established October 1, 1996 to provide Workers' Compensation insurance coverage to members of the Tennessee Valley Public Power Association domiciled in Tennessee. Since its inception, DSIF has purchased aggregate stop loss insurance coverage from Distributors Insurance Company (DIC). Losses within DSIF's retention (originally \$100,000 per occurrence and, more recently, \$250,000 per occurrence) accumulate towards the aggregate attachment point. DSIF pays the Company an insurance premium annually for the aggregate insurance protection.

Effective January 1, 2003, the Company commuted the aggregate stop loss policies issued to DSIF for the years 1996 through 2001, and entered into a loss portfolio transfer of all outstanding liabilities attributable to claims in these years from DSIF to the Company. DSIF had already pierced the aggregate attachment point for the 1996, 1997 and 1998 years, so that subsequent loss payments were already the responsibility of the Company. Although, DSIF has not yet pierced the aggregate attachment points for the 1999, 2000 and 2001 years, the actuarial projections are that this eventually will occur. In recognition of this reality and to try to simplify some of the

future accounting transactions between the Company and DSIF, the non-recurring transfer of liabilities, in exchange for a one-time premium, from DSIF to the Company for the period October 1, 1996 through December 31, 2001 was made effective January 1, 2003.

Although some of these liabilities were actuarially recognized in prior years, there was some adverse loss development that resulted in an increase in Workers' Compensation loss reserves in 2003. This is consistent with adverse trends that are in evidence for Workers' Compensation risks throughout the State of Tennessee, which have resulted in efforts on the part of several groups to revise/reform the Workers' Compensation system in the State.

In addition, the Company adopted a somewhat more conservative position on recording incurred but not reported (IBNR) loss reserves, especially with regard to Workers' Compensation claims. This resulted in total Company loss reserves as of December 31, 2003 that are near the upper end of Tillinghast-Towers Perrin's actuarial range of reasonableness, as compared to December 31, 2002 when the Company's reserves were toward the lower end of the actuarial range of reasonableness; these figures appear in the Tillinghast loss reserve analysis reports as of December 31, 2002 and December 31, 2003.

The effect of the non-recurring transaction between the Company and DSIF and the overall increase in the Company's loss reserves was to depress the Company's financial operating results in the 2003 year. As these were one-time events, the Company's 2004 performance is expected to return to its previous pattern of operating income, which has been positive throughout most of its 21-year history, as evidenced by its consistent growth of surplus to over \$9.4 million.

FINANCIAL STATEMENT

There follows a statement of assets, liabilities and statement of income at December 31, 2002 together with a reconciliation of capital and surplus for the period under review, as established by this examination:

	<u>Assets</u>		
	<u>Ledger</u> <u>Assets</u>	<u>Nonadmitted</u> <u>Assets</u>	<u>Net Admitted</u> <u>Assets</u>
Bonds	\$12,533,976		\$12,533,976
Common stocks	2,617,045		2,617,045
Cash and short-term investments	7,577		\$7,577
Premiums and agents' balances in course of collection	798,201		\$798,201
Reinsurance recoverables on loss and loss adjustment expense payments	8,873		\$8,873
Federal and foreign income tax recoverable and interest thereon	222,487	63,368	\$159,119
Interest, dividends and real estate income due and accrued	142,477		\$142,477
Receivable from parent, subsidiaries and affiliates	(170,968)		(170,968)
Aggregate write-ins for other than invested assets	<u>511,646</u>	<u> </u>	<u>\$511,646</u>
Totals	<u>\$16,671,314</u>	<u>\$63,368</u>	<u>\$16,607,946</u>

Liabilities, Surplus and Other Funds

Losses	\$3,805,107
Reinsurance payable on paid loss and loss adjustment expenses	1,110,028
Loss adjustment expenses	790,875
Other expenses	250,585
Taxes, licenses and fees	11,228
Federal and foreign income taxes	(144,113)
Unearned premiums	1,214,670
Amounts withheld or retained by company for account of others	25,000
Aggregate write-ins for liabilities	<u>86,603</u>
 Total liabilities	 7,149,983
 Common capital stock	 \$400,000
Gross paid in and contributed surplus	351,000
Unassigned funds (surplus)	<u>8,706,963</u>
 Surplus as regards policyholders	 <u>9,457,963</u>
 Total	 <u>\$16,607,946</u>

STATEMENT OF INCOME

UNDERWRITING INCOME

Premiums earned		\$2,760,131
Deductions		
Losses incurred	\$874,159	
Loss expenses incurred	471,960	
Other underwriting expenses incurred	<u>1,580,066</u>	
Total underwriting deductions		<u>\$2,926,185</u>
Net underwriting gain (loss)		(166,054)

INVESTMENT INCOME

Net investment income earned	578,739	
Net realized capital gains (losses)	<u>(654,161)</u>	
Total investment gain (loss)		(75,422)

OTHER INCOME

Aggregate write-ins for miscellaneous income	248,346	
Total other income		<u>248,346</u>
Net income before dividends to policyholders and before federal and foreign income taxes		6,870
Dividends to policyholders		<u>0</u>
Net income after dividends to policyholders and before federal and foreign income taxes		6,870
Federal and foreign income taxes incurred		<u>(32,294)</u>
Net income		<u>\$39,164</u>

CAPITAL AND SURPLUS ACCOUNT

GAINS AND (LOSSES) IN SURPLUS

Surplus as regards policyholders, December 31 prior year		\$9,336,111
Net income	39,164	
Net unrealized capital gains or losses	(14,770)	
Change in nonadmitted assets	15,302	
Aggregate write-ins for gains and losses in surplus	<u>82,156</u>	
Change in surplus as regards policyholders for the year		<u>121,852</u>
Surplus as regards policyholders, December 31 current year		<u>\$9,457,963</u>

Reconciliation of Capital and Surplus Account for the Period Under Examination

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Surplus as regards policyholders,					
December 31, previous year	\$7,106,246	\$7,767,337	\$8,399,849	\$8,762,289	\$9,336,111
Net income	454,894	599,699	466,364	439,508	39,164
Net unrealized capital gains or losses	89,102	15,166	(269,861)	(29,188)	(14,770)
Change in net deferred income tax				9,795	
Change in non-admitted assets				(78,670)	15,302
Cumulative effect of changes in accounting principles				218,104	
Aggregate write-ins for gains and losses in surplus	117,095	17,647	165,937	14,273	82,156
Net change for the year	<u>661,091</u>	<u>632,512</u>	<u>362,440</u>	<u>573,822</u>	<u>121,852</u>
Surplus as regards policyholders,					
December 31, current year	<u>\$7,767,337</u>	<u>\$8,399,849</u>	<u>\$8,762,289</u>	<u>\$9,336,111</u>	<u>\$9,457,963</u>

**ANALYSIS OF CHANGES IN FINANCIAL STATEMENT
AND COMMENTS RESULTING FROM EXAMINATION**

Differences in various items were noted during the course of examination; however, none were considered to produce a material effect on surplus funds as regards policyholders, either singly or in aggregate.

**SUMMARY SCHEDULE FOR "ANALYSIS OF CHANGES
IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM
EXAMINATION" AS THEY AFFECT SURPLUS**

No schedule or comment is applicable. All noted differences were well below the tolerable error established for examination purposes.

COMMENTS AND RECOMMENDATIONS

Comments:

Detail testing of purchases and sales of securities indicate that the Company is recording the settlement date rather than the trade date as the transaction date. The effect of this dating on the Company's amortization of securities as exhibited on Schedule D – Part 1 has an immaterial effect as the time involved is a matter of a few days. No change is proposed to the current Schedule D. The Company began reporting investments using the trade date instead of the settlement date as of the Company's June 30, 2003 quarterly statement.

- Although the Company lists a total of \$750,000 in Special Deposits in Schedule E, Part 2 of its 2002 Annual Statement, this examination has found that these are actually General Deposits, which are held for the benefit of all policyholders and creditors of the Company. This was also noted as an error in the previous examination report.

Recommendations:

- The above noted discrepancies are in violation of Tenn. Code Ann. § 56-13-113 which requires the Company to report its financial statement in such form as approved by the Commissioner.
- The Company had not filed its loss control consulting agreement and safety training agreements with its parent, TVPPA, with "The Department of Commerce and Insurance". This is in violation of Tenn. Code Ann. § 56-11-206(a)(2)(D).
- The Company's bonds, stocks and short-term investments are held in the Company's name at First Tennessee Bank, National Association under a custodial agreement. The said custodial agreement did not comply with the requirements outlined in Tenn. Comp. R. & Reg. 0780-1-46.

The bank and the Company signed an amended and restated agreement dated February 6, 2004 which complies with Tenn. Comp. R. & Reg. 0780-1-46.

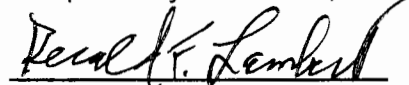
CONCLUSION

The customary insurance examination practices and procedures, as promulgated by the National Association of Insurance Commissioners, have been followed in connection with verification and valuation of assets and determination of liabilities of Distributors Insurance Company.

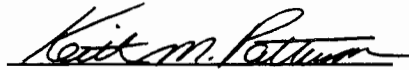
In such manner it was determined that as of December 31, 2002, the Company had admitted assets of \$16,607,946 and liabilities, exclusive of capital and surplus, of \$7,149,983. Thus there existed for the additional protection of the policyholders, the amount of \$9,457,963 in the form of common capital stock, gross paid in and contributed surplus and unassigned funds (surplus).

The courteous cooperation of the officers and employees of the Company, extended during the course of examination, is hereby acknowledged.

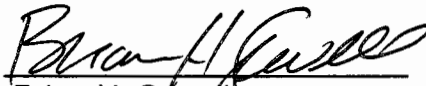
Respectfully submitted,



Gerald F. Lambert, CFE
Examiner-in-Charge
State of Tennessee
Southeastern Zone, NAIC



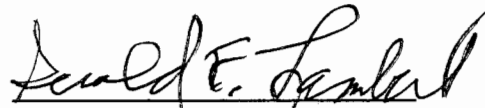
Keith M. Patterson
Insurance Examiner III
State of Tennessee
Southeastern Zone, NAIC



Brian H. Sewell
Insurance Examiner II
State of Tennessee
Southeastern Zone, NAIC

EXAMINATION AFFIDAVIT

The undersigned deposes and says that she has duly executed the attached examination report of Distributors Insurance Company, dated August 31, 2004 and made as of December 31, 2002, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says she is familiar with such instrument and the contents thereof, and the facts therein set forth are true to the best of his knowledge, information and belief.



Gerald F. Lambert, CFE
Examiner-in-Charge
State of Tennessee
Southeastern Zone, NAIC.

County Davidson

State Tennessee

Subscribed and sworn to before me
this 31st day of
August, 2004

Helen K. Darvey
(NOTARY)

My Commission Expires

03/25/06

ORGANIZATIONAL CHART

TENNESSEE VALLEY PUBLIC POWER ASSOCIATION

A Tennessee Not-For-Profit Corporation

Distributors Insurance Company

A Tennessee Association Captive Insurance Company

100% of Stock Shares Owned by TVPPA



FAXED
9-30-04

September 30, 2004

The Honorable Don Spann
Chief Examiner
TENNESSEE DEPARTMENT OF COMMERCE
AND INSURANCE
500 James Robertson Parkway
Davy Crockett Tower
Nashville, Tennessee 37243-0565

RECEIVED

OCT 04 2004

Dept. Of Commerce & Insurance
Company Examinations

Re: Distributors Insurance Company

Dear Mr. Spann:

We have enclosed for filing with the Department copies of the following agreements between Distributors Insurance Company (the "Company" or "DIC") and the Tennessee Valley Public Power Association:

1. Loss Control Consulting Agreement with Roger Plymale and R.P. & Associates.
2. Safety Training Agreement with Joe Gentry and Gentry & Associates.
3. Amended and Restated Safety Training Agreement with John Towler.

As noted in the Department's Examination Report dated August 31, 2004, DIC did not file these documents with the Department, but instead presumed that they would be covered under the Department's periodic review of cost allocations and related payments between DIC and TVPPA. We are now filing the service agreements pursuant to T.C.A. § 56-11-206(a)(2)(D), to the extent required by law. DIC respectfully requests that the Department make a note of this filing in its Examination Report.

In the course of reviewing the Company's files in preparation for this filing, DIC noted an inadvertent typographical error concerning DIC's payments for the services and costs associated with the service of John Towler. While the agreement on file with DIC indicated that the reimbursement was to be 25% of all sums paid to Towler during the term of the agreement, the correct percentage should have been 125% instead. This compensation is consistent with the general manner in which TVPPA and DIC have collected out-of-pocket and overhead costs associated with its other loss control and safety agreements. DIC and TVPPA have amended and restated the Towler agreement to correct this typographical error.

If you have any questions or need further information, please do not hesitate to contact me.

Sincerely,

R. Kent Lopez
Vice President

Enclosures

cc: Mr. Jack W. Simmons
Mr. Anthony J. Salvatore
Mr. Carlos C. Smith